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Hospitality : lodging and restaurants industry developments - 1999/2000; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Hospitality: Lodging and Restaurants Industry Developments—1999/2000

Notice to Readers

This Audit Risk Alert is intended to provide CPAs serving the lodging and restaurant industry with an overview of recent economic, industry, regulatory, and professional developments that may affect the engagements and audits they perform. The AICPA staff prepared this document. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. The discussions presented in this publication do not represent the views, positions, or opinions of the AICPA.

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In This Year's Alert...

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Keeping in Tune With the Realities of the Business Environment

What is the purpose of this Alert?

This Alert helps you expand your knowledge and understanding of the business environment in which your clients operate. This Alert helps you provide top-quality audit services to your clients in the lodging and restaurant industry and helps you provide relevant information to those clients, thus adding value to the business decision-making process. The information in this Alert bolsters your audit planning efforts in considering industry matters. Moreover, this Alert helps you analyze and interpret relevant information and converging information.

CPAs who understand what is happening in the lodging and restaurant industry, and who can interpret and add value to that information, will be able to offer valuable service and advice to their clients. This Alert assists you in making solid and rapid strides in gaining that industry information and understanding it.

It is best to read this Alert in conjunction with the AICPA general *Audit Risk Alert—1999/2000* (Product No. 022250kk). To order, call the AICPA Order Department at 1-888-777-7077.

Industry and Economic Developments

What are the current and emerging economic and industry trends?

A Robust but Slowing U.S. Economy

The U.S. economy remains strong. Although the current economic growth is not as vigorous as it was in the 1980s, the length of the economic expansion is the longest since the end of

World War II. Most of the standard indicators of health for the U.S. economy point to excellent macroeconomic conditions. Despite this robust economic activity, inflation is the lowest in a generation. At the same time, unemployment is very low and U.S. workers have posted strong gains in productivity. In spite of this activity, however, the booming U.S. economy has been exhibiting signs of slowing recently.

Consumer Spending, Business Investment Keys to Strong Economic Growth

Much of the current growth in the U.S. economy can be attributed to the deregulation and tax cutting that occurred in prior years. Furthermore, consumer spending and business investment have been the keys to the nation's economic strength. Also, the U.S. economy increasingly relies on exports to fuel its overall growth.

Consumer Spending High, Savings Rate Low. The underlying factors that drive consumer spending are strong. Low unemployment and rising real incomes have boosted consumer confidence, resulting in increased purchases of goods, including new homes and automobiles. Although real disposable personal income is growing, the personal savings rate is the lowest since the Great Depression. The decline in personal savings has prompted much discussion of its causes and potential implications for the economy.

Business Investment. Growth in business investment spending, which typically peaks in the early years of an economic expansion, has actually accelerated during the current expansion. A number of factors appear to be responsible for this investment boom, including investment in new technology and the low cost of capital.

Problems and Risks Lurking Behind the Rosy Economic Picture

Many economists believe positive conditions will continue through the year 2000, giving us yet another year of economic expansion. Nevertheless, underlying problems exist in the U.S. economy, despite its apparent strength. These problems include exorbitant consumer debt, a vulnerability to foreign financial crises, a negative savings rate, and most importantly, the growing trade deficit.

Record-Setting Trade Deficit Harmful to Economy. The strong economy and the flood of imports into the country have created a record-setting U.S. trade deficit (the measure of all goods, services, and money flowing into and out of the nation). This trade deficit reflects the big difference between the powerhouse U.S. economy and the sagging economies of many foreign countries. Foreign companies and investors target the healthy U.S. economy with their products and with their investment dollars. Often, foreign countries devalue their currencies and dump their products into the U.S. market at cheap prices. The United States has become a nation of people who consume more than they produce. The flood of imports into the nation has contributed to the dramatic decline in the country's industrial plant, manufacturing base, steel industry, textile industry, electronics industry, and other sectors of the economy.

The vast deterioration that has occurred in numerous U.S. industries may very well be a harbinger of deeper economic problems to come. Moreover, the huge trade deficit is a major problem that, when combined with a falling stock market or a falling dollar, could cause an economic crisis in the United States.

Executive Summary—A Robust but Slowing U.S. Economy

- The U.S. economy remains strong and positive conditions are predicted through 2000. Nevertheless, the economy exhibits signs of slowing.
- The deregulation and tax-cutting efforts in earlier years coupled with strong consumer spending and business investment are the keys to the robust economy.
- Serious underlying problems exist in the economy, nevertheless. They include exorbitant consumer debt, a vulnerability to foreign financial crises, a negative savings rate, and a growing trade deficit.
- The trade deficit is a major problem that, when combined with a falling stock market or a falling dollar, could cause an economic crisis.

Lodging Industry Performance

Trends in lodging industry performance align closely with those of the economy. Generally the lodging industry is healthy and exhibits solid fundamentals. However, operating profits at many lodging companies are predicted to decrease slightly, a condition attributable to lower occupancy rates and slow growth in room rates.

The robust economy and strong consumer confidence have helped the industry's performance. Leisure travel and foreign tourism (mostly to Florida, California, and New York City) have been strong, although business travel is slowing. Apparently, travel budget reductions at many businesses, rising airfare rates, and the proliferation of such technologies as video conferencing and the Internet have contributed to the decline in business travel.

Construction of new lodging units, although advancing, has slowed from recent previous boom years. The addition of new rooms related to the recent construction expansion is negatively affecting occupancy rates and room rates. Hotel construction may pick up in the near term, and concern exists about the overbuilding of hotel rooms, especially luxury rooms, in the industry.

In general, lodging entities are cutting expenses and trying to gain more revenue from operations, such as parking fees and food and beverage services. Traditionally, food and beverage operations add substantial revenue to an entity's earnings; however, their profit margins are weak.

Moving beyond the industry's financial performance, change is evident everywhere in the industry, especially in technological improvements, and Internet visibility. The timesharing sector continues to expand rapidly, as well as the extended-stay segment. Unlike recent years, though, merger and acquisition activity has slowed.

As already stated, the lodging industry largely mirrors the overall U.S. economy. If economic hard times arrive, rooms will stay empty and industry performance will deteriorate. You should keep an eye on economic conditions, especially in your geographic area, to help identify potential financial difficulties down the road for your clients.

Executive Summary—Lodging Industry Performance

- Generally, the lodging industry is healthy and exhibits solid fundamentals. However, occupancy rates and room rates are being depressed by the recent construction boom.
- Some concern exists in the lodging industry over excess supply caused by possible overbuilding.
- Technological advancements, like the Internet, are bringing rapid change to the lodging industry.

Restaurant Industry Performance

Sales volume in the restaurant industry is growing, reflecting a largely healthy business environment. Menu prices have also been rising, slightly ahead of inflation. As is the lodging industry, the restaurant sector is closely linked to the performance of the economy. Many people are enjoying higher disposable incomes and are confident about the future of the economy. They are dining out more and spending more of their food dollars in restaurants.

Most of the sales growth has been occurring in the South and West, while the Mid-Atlantic states are experiencing slower sales growth. This trend reflects the growing population in the South and West and of the above-average economic conditions in those two areas.

Competition in the industry is intense, especially in the fast-food and limited service sector. Also, the growth of new restaurants has slowed, partly due to a lack of support for such endeavors in the capital markets.

While helping spur sales growth, the healthy economy has also spurred a tight labor market. Restaurants are hard-pressed to find quality employees. Employment opportunities in the industry are so abundant that employee turnover has accelerated, as people look for and accept better offers. To recruit and retain personnel in this environment, restaurants are using many different techniques, such as providing better benefits (for example, a 401(k) retirement savings plan), issuing cash rewards, creating a more employee-friendly atmosphere, and recruiting directly at schools.

In other developments, restaurant customers are requesting vegetarian dishes and ethnic cuisine (especially Asian). Finally, restaurants are increasingly embracing technology and the Internet to help them increase their efficiency and productivity.

Helpful Restaurant Industry Statistics[1]

The National Restaurant Association issued a new *Restaurant Industry Operations Report—1999*. The Association's annual survey of restaurant income statements was conducted jointly by the association and the accounting firm of Deloitte & Touche and is based on 1998 information collected from close to 1,300 restaurants.

Highlights of the study include the following:

- Median food sales at full-service restaurants with average checks of less than $10 were $5,509 per seat in 1998.
- The average daily seat turnover for full-service restaurants with average checks of $10 or more was 0.9.
- Limited-service (fast food) restaurants posted average daily seat turnover of 4.0 in 1998—the highest among the restaurant categories covered by the study.

A copy of the *Restaurant Industry Operations Report—1999* can be obtained by calling (800) 424-5156, ext. 5375, or (202) 973-5375.

The following table presents some statistics from the report that may be of use to you on your engagement.

[1] The statistics and report results presented in this Alert are reprinted with the permission of the National Restaurant Association, www.restaurant.org.

Sales Origination and Costs as a Percentage of Sales

	Full Service: Average Check per Person $10 or More (%)	*Limited Service: Fast Food (%)*
Where it came from		
Food sales	77.7	95.4
Beverage sales	22.3	4.6
Where it went*		
Cost of food sold	27.4%	33.0%
Cost of beverages sold	6.6	3.3
Salaries and wages	29.2	29.5
Employee benefits	3.4	2.7
Direct operating expenses	7.8	6.0
Music and entertainment	0.7	0.1
Marketing	1.9	3.4
Utility services	2.1	2.8
Restaurant occupancy costs	5.3	7.4
Repairs and maintenance	1.7	1.7
Depreciation	2.0	2.3
Other operating expenses/(income)	(0.6)	(2.9)
General and administrative	4.3	3.9
Corporate overhead	2.1	2.1
Interest	1.0	1.2
Other	0.3	0.1
Pretax income	4.8	3.4

* All amounts are reflected as a percentage of sales

Executive Summary—Restaurant Industry Performance

- Sales growth in the restaurant industry is healthy, reflecting the overall robust economic conditions in the country, especially in the South and West.
- Competition in the restaurant industry is intense.
- The labor market is tight, prompting numerous restaurant entities to offer additional benefits to attract and retain employees. These benefits include retirement plans.

Troubled Debt Restructurings and Bankruptcy Reorganizations

Some lodging and restaurant entities have been in the news lately announcing debt restructurings and bankruptcy reorganizations. Given the occurrence of these events and their inherently complicated nature, we provide information in this section to remind you of the accounting requirements for entities involved in troubled debt restructurings and bankruptcy reorganizations, as well as some useful disclosure examples.

Troubled Debt Restructurings

The Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended, provides the primary guidance on accounting for troubled debt restructurings. The debtor's accounting for a troubled debt restructuring depends upon the kind of restructuring. For example, the arrangement could be a transfer of assets, a grant of equity, a modification of terms, or a combination of those kinds. In addition to the accounting requirements, FASB Statement No. 15, as amended, mandates debtors to make certain disclosures about their troubled debt restructurings.

You may also need to be familiar with the guidance contained in Emerging Issues Task Force (EITF) Issue No. 89-15, *Accounting for a Modification of Debt Terms When the Debtor Is Experiencing Financial Difficulties*, FASB Technical Bulletin (TB) 80-2, *Classification of Debt Restructurings by Debtors and Creditors*, and FASB TB 81-6, *Applicability of Statement 15 to Debtors in Bankruptcy Situations.*

Bankruptcy Reorganizations

AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, provides guidance on financial reporting by entities that reorganize under chapter 11 of title 11 of the U.S. Bankruptcy Code. SOP 90-7 distinguishes between financial reporting by the entity during the reorganization proceedings and financial reporting after the plan is confirmed by the court. The principal reporting problem during the proceedings is the measurement of liabilities subject to compromise. The principal reporting problem after the plan is confirmed is the allocation of the reorganization value to the assets of the entity. Determining the appropriate accounting in accordance with SOP 90-7 for entities in reorganization under the Bankruptcy Code requires considerable judgment. You should ensure that appropriate expertise is available in these situations.

Helpful Disclosure Examples

The following are examples of financial statement disclosures that concern entities involved with a bankruptcy reorganization. These examples are based on actual statements found in the AICPA's *Accounting Trends and Techniques*. The 1999 edition of this publication can be obtained by calling the AICPA Order Department at 1-888-777-7077. Remember that these examples are presented for informational purposes only. Financial statement preparers and auditors should consult and follow applicable GAAP regarding these matters and should consider the unique characteristics of every entity.

Example of Financial Statement Disclosure of Reorganization

On [*date*] the Company's Second Amended Plan of Reorganization (the "Plan of Reorganization") was confirmed by the United States Bankruptcy Court for the District of [*place*] (Case No. [*xx-xxx*]) (the "Bankruptcy Court"). None of the Company's foreign-base subsidiaries was part of the chapter 11 filing.

By its terms, the Plan of Reorganization becomes effective (the "Effective Date") on the first business day that is at least ten days after the Bankruptcy Court order confirming the Plan of Reorganization is entered and on which no stay of such order is then in effect. On [*date*], the Bankruptcy Court entered its order confirming the Plan of Reorganization. Accordingly, the Effective Date of the Plan of Reorganization is [*date*].

On [*date*] (the "Filing Date") the Company filed a voluntary petition (the "Chapter 11 Case") under chapter 11 of the United States Bankruptcy Code. On [*date*] the Company filed an amended plan of reorganization and related disclosure statement with the Bankruptcy Court. On [*date*], the Bankruptcy Court approved as adequate the Disclosure Statement, thereby enabling the Company to solicit votes on the Plan of Reorganization from the Company's secured lenders (collectively, the "Lender Group") and stockholders. From the Filing Date until the Effective Date, the Company operated its business as a debtor-in-possession subject to the jurisdiction of the Bankruptcy Court. During such time, all claims against the Company in existence prior to the Filing Date were stayed and have been classified as "liabilities subject to compromise" in the consolidated balance sheet.

At [*date*] "liabilities subject to compromise" were comprised of the following:

[*Item*]	[*Dollar amount*]
[*Item*]	[*Dollar amount*]
[*Item*]	[*Dollar amount*]
[*Item*]	[*Dollar amount*]

Example of "Basis of Presentation" Disclosure in Significant Accounting Policies Footnote, Related to a Bankruptcy Reorganization

On [*date*], with the approval of all voting classes of creditors and equity holders, the United States Bankruptcy Court for [*location*] confirmed the Debtors Modified Amended Consolidated Plan of Reorganization dated [*date*] (the "plan"). On [*date*] the plan became effective. For accounting purposes, the effective date of the plan is considered to be [*date*].

Upon emergence from its chapter 11 proceedings, the Company issued new common stock, warrants to purchase common stock, and senior notes and created a newly formed liquidating subsidiary, [*name*], which issued certain asset proceeds notes to be redeemed from the proceeds of sales of noncore assets.

The Company adopted "fresh-start" reporting in accordance with AICPA Statement of Position No. 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* ("SOP No. 90-7"), as of [*date*]. The Company's emergence from its chapter 11 proceedings resulted in a new reporting entity with no retained earnings or accumulated deficit as of [*date*].

Accordingly, the Company's consolidated financial statements for periods prior to [*date*] are not comparable to consolidated financial statements presented on or subsequent to [*date*]. A black line has been drawn on the accompanying consolidated financial statements to distinguish between the pre-reorganization and post-reorganization company.

Reporting by Lodging Management Companies

Accounting for the Management Agreement

Recently, some lodging management companies have asserted that the agreements under which they manage hotel properties are, in substance, leases. As such, the arrangements are required to be accounted for pursuant to FASB Statement No. 13, *Accounting for Leases*. Determining whether a contract is a service agreement or a lease is dependent on the facts and circumstances and requires a rigorous analysis of the rights, obligations, risks, and rewards of the management company and the property owner. Management agreements generally do not convey the same rights and obligations as a lease agreement.

Consolidating Managed Hotel Properties

Some management companies, of late, believe that the management agreement provides such extensive control over the property that its consolidation, or a reporting display similar to consolidation, is appropriate. EITF Issue No. 97-2, *Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements*, should be considered in determining the appropriate accounting and reporting for managed properties. Although EITF Issue No. 97-2 addresses directly the consolidation of managed physician practices by the manager, hotel management companies should consider that guidance also to determine whether consolidation of the properties is required in their financial statements.

Consolidation of managed hotels, or any similar manner of display, is appropriate only if the management company obtains a controlling financial interest in the managed property through a contractual service agreement. The criteria indicating a controlling financial interest are specified in EITF Issue No. 97-2.

Growth of Employee Benefit Plans

The existence of employee benefit plans at restaurant and lodging entities is increasing. Recent legislative initiatives that make benefit plans more appetizing for restaurants and lodging entities and the desire to attract and retain competent employees have led numerous hospitality companies to begin offering benefit plans to their employees. These benefit plans include retirement plans and health and welfare benefit plans.

You may be asked by the owners and management of your restaurant and lodging clients for advice on such benefit plan issues as accounting matters, regulatory requirements, and the advantages and disadvantages of different kinds of plans. Moreover, you may need to audit or may already be auditing the employee benefit plans of your clients in the lodging and restaurant industry. The following sections contain some important reminders and information about employee benefit plans.

Auditing and Accounting Guidance

The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* provides guidance on accounting, auditing, and reporting on the financial statements of employee benefit plans. The Guide applies to defined benefit pension plans, defined contribution pension plans, and defined benefit and defined contribution health and welfare benefit plans. The Guide applies to audits of financial statements and supplementary schedules, as applicable, of plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as well as to those that are not.

Governmental Regulations

ERISA provides for substantial federal government oversight of the operating and reporting practices of employee benefit plans.

Employee benefit plans that are subject to ERISA are required to report certain information annually to federal government agencies (for example, the Department of Labor, Internal Revenue Service [IRS], and Pension Benefit Guaranty Corporation) and to provide summarized information to plan participants. For many plans, the information is reported to the IRS on Form 5500, *Annual Return/Report of Employee Benefit Plan.*

ERISA contains a requirement for annual audits of benefit plan financial statements by an independent qualified public accountant. Generally, plans with 100 or more participants are subject to the audit requirement. Appendix A of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* contains information on ERISA and related regulations and which plans are subject to ERISA.

Deficiencies on Audits of Employee Benefit Plans

Some common, recurring deficiencies identified by the AICPA Peer Review Board in its review of employee benefit plans are—

- Inadequate testing of participant data.
- Inadequate testing of investments.
- Failure to understand testing requirements on a limited-scope engagement.
- Inadequate or no documentation of the auditor's understanding of internal control.
- Inadequate consideration of prohibited transactions.
- Incomplete description of the plan and its provisions.
- Inadequate or missing disclosures related to investments.
- Inadequate or missing disclosures related to participant data.
- Failure to properly report on or include the required supplemental schedules required by ERISA or DOL.

The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* provides guidance concerning areas in which the Peer Review Board noted deficiencies.

Audit Risk Alert

The AICPA Audit Risk Alert *Employee Benefit Plans Industry Developments—1999/2000* provides auditors of financial statements of employee benefit plans with an overview of recent industry, regulatory, and professional developments that may affect the audits they perform. This Alert can be obtained by calling the AICPA Order Department at 1-888-777-7077 and asking for product number 022214kk.

Practice Aid

The AICPA Practice Aid *Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans* (Product No. 008725kk) provides illustrative disclosures for financial statements of employee benefit plans. Offering the same kind of powerful help AICPA's *Accounting Trends & Techniques* does, this comprehensive Practice Aid illustrates a wide range of employee benefit plan financial statement disclosures and auditor's reports for both full-scope and limited-scope audits. Also included are illustrative Form 5500 schedules.

In Focus Special: Managing Profits

What are some of the reasons behind and methods of manipulating earnings?

Management teams of publicly held lodging and restaurant entities, like their counterparts in other industries, may be subject to unusually high pressure to release earnings statements that meet analysts' expectations. In today's marketplace, if management fails to meet earnings expectations, the market value of the entity's stock may decrease significantly, placing even more pressure on management to deliver better results. In addition, management teams of lodging and restaurant entities that have been involved in recent business combinations may be under stress to justify the combination to shareholders by delivering the promised fruits of those mergers.

The pressure of meeting earnings expectations or making a merger work can sometimes drive management to resort to questionable or aggressive accounting methods to report financial results that fit their needs. This desire to manage profits can also be exacerbated by the increasing use of stock options as executive compensation.

Those pressures to manage profits, added to the recent spate of corporate accounting scandals, has focused a critical eye on the role and effectiveness of audit committees. Some concern has been raised about the failure of audit committees to do their job in overseeing management and financial controls. For more information on audit committee concerns, read the "Audit Committees" section in this Alert and in *Audit Risk Alert—1999/2000.*

Common Methods Used to Manage Profits

Under the circumstances just mentioned, you should be aware of and address situations at your clients that may pressure management to manage profits. Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). Among other things, SAS No. 82 provides examples of risk factors relating to misstatements arising from fraudulent financial reporting. Among those factors is an excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices. Some of the more common methods used to manage profits include—

- Excessive accruals or manipulations of accruals for restructuring charges and similar items.

- Misuse of the concept of materiality.
- Improper write-downs of assets that continue to be used in operations.
- Unreasonable lives for depreciation and amortization.
- Improper recognition of future operating losses or deferral of current operating losses.
- Front-end recognition of revenues despite expectations for significant future performance or the existence of material obligations or uncertainties affecting realization, or deferral when all criteria for recognition are met.
- Improper application of authoritative literature governing impairment.
- Improper application of conservatism (see paragraphs 91-96 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*).

Accounting and auditing guidance for some of these areas are discussed in the following sections.

Revenue Recognition at Lodging and Restaurant Entities

Accounting Guidance

Revenues should not be recognized until earned. A lodging or restaurant entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

Revenue from service transactions should be recognized based on performance. If performance consists of a single act, revenue should be recognized when that act takes place. If performance consists of multiple acts, revenue should be recognized based on the proportionate performance of each act. If there is a significant degree of uncertainty regarding realization of service revenue, revenue should not be recognized until collection.

Franchise Sales. Franchise fee revenue from an individual franchise sale ordinarily shall be recognized when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. Substantial performance for the franchisor means that (1) the franchisor has no remaining obligation or intent to refund any cash received or forgive any unpaid notes or receivables, (2) substantially all the initial services of the franchisor required by the franchise agreement have been performed, and (3) no other material conditions or obligations related to the determination of substantial performance exist.

FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, provides guidance in this area. FASB Statement No. 45 should be applied only if the arrangement meets the definition of a franchise agreement as described in FASB Statement No. 45. Marketing agreements that do not meet all the criteria of a franchise agreement as defined in FASB Statement No. 45 should not be accounted for under FASB Statement No. 45, but rather recognized as the marketing services are performed.

Misstated Revenue. Misstatements in reported revenue may result from error or from faulty judgment in the application of accounting principles. Management may inappropriately use aggressive accounting policies that reflect their understanding of the economic substance of the transactions and of practice in the lodging and restaurant industry. Misstatements in revenue also may arise when entity personnel at various levels participate in schemes, frequently with the collusion of others within the entity or with customers or suppliers, to overstate revenues intentionally. Intentional misstatements of the financial statements is fraudulent financial reporting.

Risk Factors

What factors might indicate an intentional misstatement of revenues? SAS No. 82 requires auditors to assess the risk of material misstatement of the financial statements due to fraud. As a part of that assessment, the auditor is required to consider whether fraud risk factors are present. Examples of risk factors that are particularly relevant to revenue recognition include the following:

- A high degree of competition or market saturation exists, accompanied by declining margins.
- An inability to generate cash flows from operations exists while the entity reports earnings and earnings growth.
- Unusually rapid growth or profitability occurs, especially compared with that of other entities in the lodging and restaurant industry.
- A significant portion of management's compensation is represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.
- Management fails to display and communicate an appropriate attitude regarding internal control and the financial reporting process.

If these or other fraud risk factors are present, the auditor is required to make certain considerations, as outlined in SAS No. 82. If a risk of fraudulent financial reporting related to revenue recognition is identified, specific responses might include the assignment of more senior or experienced personnel to plan and perform the auditing procedures related to revenues, increased sensitivity in the selection of the nature and extent of documentation to be examined, and increased recognition of the need to corroborate management explanations or representations.

Some Useful Tests of Revenue

Room Revenue. You may find it useful to test room revenue analytically by using independent sources to estimate what the revenue should be. In using an independent source, you would not be relying on sources that are part of the transaction process or source documents. Instead you might attempt to estimate sales through the use of such sources as the housekeeper's report.

Room revenue could be estimated by pricing out the housekeeper's report using an average room rate. Another possible independent source is the bell captain's log, which keeps a record of bellhops escorting customers to their rooms. Still another independent source could be the electronic key card report, which lists the electronic key cards that are generated for every room sold. See SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), for further guidance.

Restaurant Revenue. Understanding how the restaurant controls cash is an important and effective way in ascertaining the reasonableness of reported revenue. Effective controls, such as the division of cash handling responsibilities, surprise cash counts, using a daily cash report, and making daily deposits, should be in place. In addition to looking at controls, you can also perform analytical tests by comparing restaurant sales by month or by week to prior periods and determining the reasonableness of those results.

Accounting for Restructuring Charges

EITF Guidance and Having a Management Plan

Combining restaurant or lodging companies often restructure their operations. Auditors should consider whether management has appropriately accounted for restructuring costs in accordance with the requirements of EITF Issue Nos. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination.*

To justify restructuring-related charges, authoritative literature requires the existence of an approved management plan as of the date of the financial statements. Management's plan must be comprehensive, explicit, and adequately documented to provide objective evidence of management's intent.

Loss recognition that is based on management's intent must be supported by objective evidence of intent. To demonstrate management's intent, you may want to consider whether the plan is sufficiently developed to forecast its consequences and management's commitment to ultimately implement the plan as contemplated. A documented and appropriately approved management plan that is comprehensive and explicit should exist to accrue a liability.

Making Required Disclosures

When liabilities are accrued in accordance with the guidance in EITF Issue Nos. 94-3 and 95-3, certain disclosures are required. The thresholds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity or involuntarily terminate employees of an acquired company have been fully executed. For instance, under EITF Issue No. 94-3, the amount of actual termination benefits paid and charged against the liability and the number of employees actually terminated as a result of the plan to terminate the employees must be disclosed. The amount of any adjustments to the liability also must be disclosed.

Making Sure Accruals Are Not "Cushions"

The SEC staff has observed an increasing frequency of subsequent reductions to restructuring liabilities, which suggests that management may be "providing a cushion" in establishing such reserves. When reviewing management's accruals, you should be aware of the kinds of charges that are allowed to be accrued for, pursuant to EITF Issue Nos. 94-3 and 95-3, and other relevant accounting literature, as appropriate.

In addition, the SEC staff has stated that liabilities accrued in accordance with EITF Issue Nos. 94-3 and 95-3 are valuation accounts that should be disclosed on Schedule II, Valuation and Qualifying Accounts, of SEC registrants' annual reports filed on Form 10-K.

Misusing Materiality

Management of some restaurant or lodging companies may misuse the concept of materiality when preparing and reporting financial information. They may allow errors to be recorded within a defined percentage ceiling and claim that the effect on net income is too small to matter.

Quantitatively immaterial departures from generally accepted accounting principles (GAAP) may be qualitatively material if they are designed, for example, to maintain earnings trends or hide a failure to meet analysts' consensus expectations.

Auditors should assess the qualitative factors important in determining whether information would be considered material to investors. The use of quantitative factors alone is not sufficient. In addition, known errors that have not been recorded based solely on a quantitative materiality factor, especially intentional errors, should be addressed. When qualitative materiality significantly alters the apparent significance of a matter, the pertinent information should be adjusted or disclosed.

When considering issues of materiality, auditors of public companies are expected to consider guidance that is already provided in several important areas, including court decisions and SEC rules, regulations, and enforcement actions, as well as accounting and auditing literature.

Guidance Being Issued

SEC Staff Accounting Bulletins

The SEC has released Staff Accounting Bulletin (SAB) No. 99, *Materiality*, which addresses the application of materiality thresholds to the preparation and audit of financial statements. The SEC staff has also recently issued SAB No. 100, *Restructuring and Impairment Charges*. This SAB addresses the accounting for and disclosure of certain expenses commonly reported in connection with exit activities and business combinations. These new SABs are discussed in the "Recent SEC Regulatory Actions" section of this Alert. The SEC plans to issue a SAB dealing with revenue recognition. If appropriate to your circumstances, you may want to keep abreast of the status of this planned SAB.

Revenue Recognition

The AICPA has issued a nonauthoritative publication titled *Audit Issues in Revenue Recognition.* In this publication, the AICPA's intent is to help auditors fulfill their professional responsibilities with regard to auditing assertions about revenue. This publication can be obtained online at www.aicpa.org (go to Members, Teams, Audit and Attest Standards Team, Technical Activities, and Publications).

Audit Committees

Finally, a blue ribbon committee of accounting representatives, stock market regulators, and corporate executives has published a report titled *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.* The SEC is expected to use the recommendations made by this committee. Copies of this report can be obtained by calling the New York Stock Exchange at (212) 656-2017, or by calling the National Association of Securities Dealers at (202) 728-8340. The report may also be found online at www.nyse.com or www.nasd.com.

A full discussion of recent matters related to communications with audit committees can be read in *Audit Risk Alert—1999/2000.*

Executive Summary—In Focus Special: Managing Profits

- The pressure of meeting earnings expectations or making a merger work can sometimes drive management to resort to questionable accounting methods designed to manage profits.
- Common methods used to manage profits include managing revenue recognition and accruals for restructuring charges and misusing materiality.
- Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

- EITF Issues 94-3 and 95-3 address the accounting for restructuring charges.
- Recent guidance addressing the problem of managing profits includes SEC SAB Nos. 99 (on materiality) and 100 (on restructuring and impairment charges), the AICPA's *Audit Issues in Revenue Recognition*, and a blue ribbon committee report on the effectiveness of audit committees.

Current Technologies Affecting Your Engagement

How do the year 2000 and electronic commerce affect the audit engagement?

The Year 2000

By this time, management of lodging and restaurant entities should have assessed their year 2000 situation. The Year 2000 Issue relates to the inability of many information technology based systems to accurately process year-date data beyond the year 1999.

Unless year 2000 problems are remedied, significant problems relating to the integrity of all electronically processed information based on time may occur. To further complicate the issue, even if an entity's computer software and hardware are year 2000 ready, the entity may be affected by the computer systems of customers, vendors, or third-party data processing services that are not year 2000 ready.

Clearly, the Year 2000 Issue has the potential to adversely affect the operations of entities that rely, directly or indirectly, on information technology.

Some Important Year 2000 Considerations for Lodging and Restaurant Entities

As already stated, management should have assessed what effect the year 2000 will have on their operations and should be taking steps to address any potential problems. Even the smallest lodging entities and restaurant entities could be substantially affected by the year 2000 issue. All sorts of electronic systems, including point of sales, inventory, financial reporting, guest accounting, automated payroll, heating and air conditioning, and security, as well as electronic devices such as elevators, phones, faxes, and cooking equipment could be affected by year 2000 failures. Moreover, businesses that lodging and restaurant entities depend on, such as suppliers, may not be year 2000-ready.

The year 2000 issue is not just a technology issue, but a much broader business issue. Lodging and restaurant entities could face legal liabilities related to customers, employees, and stockholders if year 2000 problems are not addressed.

Solutions and Contingency Plans. Management needs to ensure that its infrastructure and suppliers and other businesses with which it interacts are year 2000-ready. Management also needs to develop contingency plans to handle problems that might occur. Affected programs need to be modified or replaced and then tested to ensure their reliability. All appropriate employees need to know what contingency plans exist for every system that may fail due to year 2000 problems.

Accounting and Auditing Guidance for CPAs

CPAs need to be aware of the risks associated with the year 2000 issue, the year 2000 accounting and auditing guidance that have been developed, and their related responsibilities.

First, it must be understood that it is the responsibility of an entity's management—not of the auditor—to assess and remedy the effects of the year 2000 on an entity's systems. The year 2000 does not create additional responsibilities for the auditor. Under GAAS, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the year 2000 or by some other cause.

Many auditing and accounting issues exist related to the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. These issues are fully discussed in the AICPA general *Audit Risk Alert—1999/2000.*

Executive Summary—The Year 2000

- Many computerized systems and electronic devices used by lodging and restaurant entities could experience failure or operating difficulties as a result of the century date change.
- Management needs to ensure that its infrastructure and suppliers are year 2000-ready and contingency plans are in place to handle any disruptions.
- CPAs need to be aware of the risks associated with the Year 2000 Issue, the year 2000 accounting and auditing guidance that have been developed, and their related responsibilities.
- The AICPA general *Audit Risk Alert—1999/2000* contains a thorough description of year 2000 audit and accounting issues.

Electronic Commerce Introduces Additional Risks and Control Considerations

Electronic commerce is increasingly gaining acceptance in the lodging industry. Electronic commerce is being applied in a variety of ways, including booking room reservations online, purchasing of goods and services online, electronic transaction processing, and electronic storefronts. These technological innovations are linking internal systems and external parties, such as customers and suppliers, together. Indeed, the Internet appears poised to substantially alter the economics and operations of the lodging industry.

The broad-based acceptance of electronic commerce by the business community, along with rapid technological advancements, has resulted in an increase in the volume and types of business transactions being conducted electronically.

Potential Abuses and Concerns

Traditional electronic data interchange (EDI) transactions are typically conducted between parties that are acknowledged trading partners. These arrangements are typically formalized by a contract that sets forth key transaction and dispute-resolution principles. Unlike EDI, however, many of today's electronic transactions are being conducted over unsecured networks, such as the Internet. As a result, the potential for fraud, dispute, and other business risks is much greater. In addition, other problems, many of which are unique to electronic environments, will need to be addressed. Some of the potential abuses and concerns that are likely to proliferate in this new environment include the following:

- Attackers or competitors may attempt to circumvent a system's security to obtain access to confidential data, steal proprietary information, intentionally corrupt information, misappropriate funds, and so on.
- Transactions traveling through a network are likely to be subject to numerous processing steps, translations, and other processes. These activities introduce such risks as unintentional errors, lost transactions, and duplication of transactions.
- Electronic messages lack traditional identifiers (for example, letterheads, logos, authorizing signatures, face-to-face contact, and the like) and thereby increase the risk that you may unintentionally deal with the wrong party or with someone impersonating another party.
- The use of digital signatures and other encryption technology may mitigate transaction authentication risks. These technologies often require the services of a trusted individual or trusted system to verify that keys and digital signatures actually belong to a designated individual (similar to a notary public function or a securities signature guarantee). There is the risk of abuse of this trusted relationship and a related need for assurance regarding the activities of the trustee (organization, individual, system, and so on).

Lodging and other hospitality entities involved in electronic commerce must establish policies to address the potential risks posed, including—

- The risk that the integrity of the entity's financial information may be compromised.
- The risk of unauthorized access to the entity's systems and databases.

Advice to Help You Audit in an Electronic Commerce Environment

Electronic commerce may allow for unauthorized access to a lodging entity's financial information processing systems and databases. Therefore, you may want to understand the entity's internal control over and assess the control risk associated with access to the financial systems and databases supporting the preparation of financial statements. In connection with these procedures, you may consider (1) controls over user access to financial information processing systems, including program changes, and access to data files; (2) controls over the accurate conversion of data to new or upgraded systems and the implications for financial reporting; and (3) new technology developments and budgets for technology upgrades.

Auditors finding it necessary to test the controls over electronic commerce may consider the use of computer-assisted auditing techniques to assess the ability of unauthorized access into the entity's financial information technology. Moreover, you may want to consider using continuous audit practices to test the effectiveness of controls. A continuous audit is defined as a methodology that enables auditors to provide written assurance on a subject matter using a series of auditors' reports issued simultaneously with, or a short period of time after, the occurrence of events underlying the subject matter. (The AICPA has published a Research Report titled *Continuous Auditing*, which can be obtained by calling the AICPA at 1-888-777-7077 and asking for Product No. 022510kk.)

SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance for auditors who have been engaged to audit an entity's financial statements when significant information is transmitted, processed, maintained, or accessed electronically. In addition, the AICPA Auditing Procedure Study *The Information Technology Age: Evidential Matter in the Electronic Environment* provides additional guidance on applying SAS No. 31 in the audit of financial statements of an entity where significant information is transmitted, processed, maintained, or accessed electronically.

> **Help Desk**—In an attempt to develop greater credibility for electronic commerce conducted on the Internet and expand the base of assurance services that CPAs can offer, the CPA WebTrust™ Seal of assurance was developed by the AICPA. The WebTrust Seal provides assurance to online customers that the business entity behind the Web site is legitimate and adheres to a standard set of business practices and controls. Specific information on obtaining WebTrust certification can be obtained by calling the AICPA at (212) 596-6146, or by ordering the AICPA Assurance Services Alert, *CPA WebTrust—1999* (Product No. 022232kk) at (888) 777-7077. In addition, we will soon be publishing a Practitioner's Guide to conducting WebTrust engagements. Check with the AICPA for the status of that guide.

Executive Summary—Electronic Commerce Introduces Additional Risks and Control Considerations

- Many of today's electronic transactions are being conducted over unsecured networks, such as the Internet. As a result, the potential for fraud, dispute, and other business risks is great.
- Some of the potential abuses and concerns are the circumvention of the system's security to access confidential data, the risk of dealing with the wrong party, and the reliance on a trusted entity to mitigate authentication risk.
- Entities must develop effective electronic commerce policies to address the risks posed.
- You may want to evaluate the entity's internal control over and assess the control risk associated with access to the entity's financial systems and databases.

Independence and Ethics Alert

What new independence and ethics information do you need to be aware of?

Complying With Independence Requirements

As a CPA, you should be independent in the performance of professional services as required by standards promulgated by the AICPA Council. In the performance of professional services requiring independence, you should consult the rules of your state board of public accountancy; your state CPA society, if applicable; the Independence Standards Board, if your client is a registrant of the SEC; the U.S. Department of Labor (DOL), if your client or the client's sponsor is required to report to the DOL; and any other regulatory or private organization that issues or enforces standards of independence.

Maintain a Quality Control System to Identify Independence Issues

The key to maintaining auditor independence is effective quality controls that identify and resolve auditor independence issues before an audit engagement. Quality Control Standard No. 2, *System of Quality Control for a CPA Firms' Accounting and Auditing Practice*[2] (AICPA, *Professional Standards*, vol. 2, QC sec. 20.09), requires that "policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances." Such quality controls may include the maintenance of a routinely updated database of clients and affiliates; a system for recording security purchases made by your employees, partners, and your firm's retirement plan; and a matching of those security purchases with the database of clients.

Follow the AICPA Code of Professional Conduct

You are bound by the AICPA Code of Professional Conduct. Among the standards included in the Code are those relating to independence.

[2] Firms that are enrolled in an AICPA-approved practice-monitoring program are obligated to adhere to quality control standards established by the AICPA.

Help Desk—You can get help with independence or other ethics-related questions by calling the AICPA Ethics Hotline at (888) 777-7077. The *Code of Professional Conduct* can be ordered by calling the AICPA Order Department at the same phone number.

Remember to read the "Professional Ethics Rulings and Interpretations" section of this Alert for recently issued statements concerning independence and ethics.

Independence Standards Board Issues Guidance

The Independence Standards Board (ISB) pronouncements apply to auditors of domestic and foreign registrants. ISB pronouncements would also apply where a regulatory agency undertakes to have auditors of entities under its jurisdiction comply with SEC Independence Rules. Also, an auditor might contractually obligate himself to follow SEC regulation S-X. An example might be a private company intending to have a public offering in the future and the desire of management to have the auditor meet all SEC requirements. The ISB recently took the following actions.

Issuance of ISB Standard No. 1, *Independence Discussions with Audit Committees*

This Standard requires an auditor of a public company to at least annually—

- Disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence.
- Confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the securities acts.
- Discuss its independence with the audit committee.

This Standard is effective for audits of companies with fiscal years ending after July 15, 1999, with earlier application encouraged. The Standard is posted on the ISB Web site at www.cpaindependence.org.

AICPA Implementation Guidance. The AICPA issued Practice Alert 99-1, *Guidance for Independence Discussions With Audit Committees*, to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating with audit committees those judgmental matters that may reasonably be thought to bear on the auditor's independence. The Practice Alert provides examples of certain relationships that may be thought to bear on the auditor's independence, safeguards to ensure independence, a sample letter to an audit committee, and other implementation guidance. Practice Alert 99-1 can be found on the AICPA Web site at www.aicpa.org.

Issuance of ISB Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)*

This Interpretation provides guidance on the auditor independence implications of likely areas of requested assistance, solely with respect to the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The ISB has concluded that the auditor may provide consulting services on the proper application of FASB Statement No. 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4 of the Interpretation, the auditor may not prepare accounting entries, compute derivative values, or be responsible for key assumptions or inputs used by the client in computing derivative values. The Interpretation includes illustrative lists of permitted and prohibited services.

This particular project made clear the need for general guidance on the extent of assistance that you can provide your audit clients when providing asset valuation services without impairing your independence. Accordingly, the ISB has established a task force to provide guidance on the provision of certain auditor appraisal and valuation services and the impact on the auditor's independence.

Release for Public Comment of Discussion Memo 99-1, *Employment with Audit Clients*

This Discussion Memo (DM) addresses the independence implications of auditors going to work for their audit clients. The DM outlines the potential threats to auditor independence posed by auditor employment by clients and presents the pros and cons of safeguards as an approach to protect auditor independence versus a "mandatory cooling-off period" (a period of time that must elapse before an auditor takes a job at the client to prevent a compromise of his or her former firm's independence). DM 99-1 can be obtained at the ISB Web site.

The ISB is expected to consider comments received on DM 99-1 and issue an exposure draft on new standards for public comment in the fourth quarter of 1999.

Release for Public Comment of DM 99-2, *Evolving Forms of Firm Structure and Organization*

This DM investigates such issues as the independence implications of corporations buying the nonattest business of accounting firms, employing the auditor on a part-time basis, and public offerings of an interest in a firm's consulting practice. The DM attempts to identify threats to auditor independence that are common to these structures, so any resulting guidance can be applied, by analogy, to new structures not yet contemplated.

Issuance of Invitation to Comment 99-1, *Family Relationships Between the Auditor and the Audit Client*

This Invitation to Comment (ITC) addresses the independence ramifications of family relationships between audit firm professionals and officers and employees of an audit client. The ITC discusses possible threats to independence, controls that CPA firms could implement, and the existence of certain family relationships that might impair independence despite mitigating controls. ITC 99-1 can be obtained at the ISB Web site.

Other Issues

The ISB is considering and working on a variety of issues, including a conceptual framework that will serve as the foundation for the development of principles-based independence standards. Other projects on its agenda include mutual funds, outsourcing arrangements, and legal services. Issue summaries and other information can be obtained at the ISB Web site.

Professional Ethics Rulings and Interpretations

For full information about the interpretations and rulings discussed in this section, visit the Professional Ethics Team Web page at www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077, menu option 2, followed by menu option 2.

AICPA Code of Professional Conduct Revisions

The Professional Ethics Executive Committee revised the following Interpretations to the AICPA Code of Professional Conduct:

- Interpretation No. 101-3, "Performance of Other Services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05) (Interpretation 101-3 addresses the performance of other nonattest services for attest clients.)

The committee also deleted the following ethics rulings under Rule 101, as they have been incorporated into this revised Interpretation: Ruling No. 3, "Member as Signer or Cosigner of Checks," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.005–.006); Ruling No. 4, "Payroll Preparation Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.007–.008); Ruling No. 7, "Member Providing Contract Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.013–.014); Ruling No. 39, "Member as Officially Appointed Stock Transfer Agent or Registrar," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.077–.078); Ruling No. 51, "Member Providing Legal Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.101–.102); Ruling No. 54, "Member Providing Appraisal, Valuation, or Actuarial Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.107–.108); Ruling No. 55, "Independence During Systems Implementation," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.109–.110); and Ruling No. 56, "Executive Search," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.111–.112).

- Interpretation No. 102-1, "Knowing Misrepresentations in the Preparation of Financial Statements or Records," of ET section 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102.02)
- Interpretation No. 501-4, "Negligence in the Preparation of Financial Statements or Records," of ET section 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.05)
- "Interpretation Addressing the Applicability of the AICPA Code of Professional Conduct," of ET section 91, *Applicability* (AICPA, *Professional Standards*, vol. 2, ET sec. 91.02)
- "Client," of ET section 92, *Definitions* (AICPA, *Professional Standards*, vol. 2, ET sec. 92.01)
- Interpretation No. 101-2, "Former Practitioners and Firm Independence," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.04)
- Interpretation No. 505-2, "Application of Rules of Conduct to Members Who Own a Separate Business," of ET section 505, *Form of Organization and Name* (AICPA, *Professional Standards*, vol. 2, ET sec. 505.03)
- Interpretation No. 101-1, "Interpretation of Rule 101," of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)

- Interpretation No. 101-13, "Extended Audit Services," of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.15)

New Ethics Interpretations Adopted

The Professional Ethics Executive Committee adopted the following new Ethics Interpretations:

- Interpretation No. 501-7, "Failure to File Tax Return or Pay Tax Liability," of ET section 501 (AICPA, *Professional Standards*, vol. 2, ET sec. 501.08)
- Interpretation No. 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.16)
- Interpretation No. 505-3, "Application of Rule 505 to Alternative Practice Structures," of ET section 505 (AICPA, *Professional Standards*, vol. 2, ET sec. 505.04)

Ethics Interpretation Deleted

The Professional Ethics Executive Committee deleted the following Interpretation:

- Interpretation No. 505-1, "Investment in Accounting Organization," of ET section 505 (AICPA, *Professional Standards*, vol. 2, ET sec. 505.02)

Ruling Revised

The Professional Ethics Executive Committee revised the following ruling:

- Ruling No. 191, "Member Removing Client Files From an Accounting Firm," of ET section 591, *Ethics Rulings on Other Responsibilities and Practices* (AICPA, *Professional Standards*, vol. 2, ET sec. 591.381–.382)

Ethics Rulings Adopted

The Professional Ethics Executive Committee adopted the following new ethics rulings:

- Ruling No. 110, "Member Is Connected With an Entity That Has a Loan to or From a Client," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.220-221)
- Ruling No. 24, "Investment Advisory Services," of ET section 391, Ethics Rulings on Responsibilities to Clients (AICPA, *Professional Standards*, vol. 2, ET sec. 391.047–.048)
- Ruling No. 25, "Commission and Contingent Fee Arrangements With Nonattest Client," of ET section 302, *Contingent Fees* (AICPA, *Professional Standards*, vol. 2, ET sec. 391.049–.050)
- Ruling No. 192, "Commission and Contingent Fee Arrangements With Nonattest Client," of ET section 503 (AICPA, *Professional Standards*, vol. 2, ET sec. 591.383–.384)
- Ruling No. 109, "Member's Investment in Financial Services Products That Invest in Clients," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.218–.219)

Ethics Rulings Deleted

The Professional Ethics Executive Committee deleted the following ethics rulings:

- Ruling No. 22, "Member Removing Client Files From an Accounting Firm," of ET section 391 (AICPA, *Professional Standards*, vol. 2, ET section 391.043–.044)
- Ruling No. 139, "Partnership with Non-CPA," of ET section 591 (AICPA, *Professional Standards*, vol. 2, ET sec. 591.277–.278)
- Ruling No. 158, "Operation of Separate Data Processing Business by a Public Practitioner," of ET section 591 (AICPA, *Professional Standards*, vol. 2, ET sec. 591.315–.316)

- Ruling No. 146, "Membership Designation," of ET section 591 (AICPA, *Professional Standards,* vol. 2, ET sec. 591.291–.292)

Also note that the Professional Ethics Executive Committee has inserted new language to the Interpretations under Rule 101, *Independence,* emphasizing that other regulatory agencies may have independence rules that are more restrictive than those of the AICPA. In addition, certain wording pertaining to the effect of interpretations and rulings that existed before the adoption of the Professional Code of Conduct on January 12, 1988 was deleted. This change affects AICPA *Professional Standards* ET sections 101, 102, 191, 201, 202, 203, 291, 301, 391, 501, 502, 503, 505, and 591.

Executive Summary—Independence and Ethics Alert

- The key to maintaining auditor independence is effective quality controls that identify and resolve auditor independence issues before an audit engagement.
- The ISB has issued a number of a statements, including ISB Standard No. 1, *Independence Discussions with Audit Committees.* The AICPA has issued Practice Alert 99-1 to help implement the ISB Standard.
- The Professional Ethics Executive Committee has issued numerous new and revised rulings and interpretations, as well as deleting some old ones. See the list in this section.

The Global Marketplace

What international events and trends may affect your clients?

Overview of Foreign Economies

The economic crisis that battered economies in Asia, Latin America, Russia, and the Pacific Rim during the second half of 1998 is no longer at a crisis level. Many financial and economic indicators point to recoveries in many of the countries affected by the crisis. Significantly, investors are returning to these foreign economies in strength. However, deep problems remain in many foreign economies.

Asia, Pacific Rim, Latin America

The recovery taking place in Asia, the Pacific Rim, and Latin America is promising. Stock markets are performing well and no currency devaluations appear on the horizon. However, the fundamental reforms and restructurings so needed in the economies of countries such as Japan, South Korea, Communist China, Malaysia, Thailand, Indonesia, Brazil, and Argentina have not been realized and are proceeding slowly. Thus, many of these economies are susceptible to another economic crisis.

Moreover, the recent violence in East Timor could possibly further destabilize economies throughout the region, if trade, investment, and lending to the region are curtailed.

Western Europe

With increases in exports and consumer demand, many economies in Western Europe are looking at moderate growth, with Germany's economy growing at a slower pace than other European countries. It appears that an economic recovery is strongly in place throughout Western Europe.

Russia

The Russian economy remains a disaster. In the kleptocracy of Russia, there is little rule of law, just centers of power. Substantial amounts of the money that comes in from the International Monetary Fund and elsewhere may be shipped to personal offshore bank accounts. The massive structural reforms that the economy requires are not being addressed. The Russian economy remains a high risk for investors and companies doing business there.

Accounting and Auditing Issues

Foreign Currency Transactions and Derivatives. Greater risk exists with companies involved in derivatives, assets, and foreign-currency-related investments and transactions related to troubled countries. Auditors may need to determine whether management has appropriately assessed the performance of its assets and derivatives related to those troubled foreign economies and whether such balances should be written down or charged off. Also, auditors should consider whether management has appropriately accounted for, and made all required disclosures relating to, foreign-currency translation, transactions arising from the translation of asset and liability positions, and revenue and expense transactions in currencies other than the U.S. dollar pursuant to FASB Statement No. 52, *Foreign Currency Translation.*

Uncertainties and Concentrations. Foreign economic difficulties may also result in a greater number of risks and uncertainties for many companies, particularly with regard to current vulnerability due to certain concentrations. Auditors should consider whether management has appropriately evaluated all such risks and uncertainties and made the necessary disclosures pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* In addition, auditors also may want to evaluate management's consideration of related contingencies arising from foreign difficulties, pursuant to FASB Statement No. 5, *Accounting for Contingencies.*

Executive Summary—Overview of Foreign Economies

- The economic crisis that enveloped Russia and many countries in Asia, Latin America, and the Pacific Rim has lessened, and many of those countries are undergoing recovery. However, deep problems remain in some of those economies.
- Auditors may need to determine whether management has appropriately assessed the performance of its assets and derivatives related to troubled foreign economies.
- You should consider whether management has appropriately accounted for, and made all required disclosures relating to, foreign-currency translations and transactions.
- You should consider whether management has appropriately evaluated risks, uncertainties, and contingencies related to foreign troubles and complied with the guidance in SOP 94-6 and FASB Statement No. 5.

Euro Generates Accounting Issues and Auditing Concerns

You may need to help your clients understand the complexities of euro currency conversion and determine whether compliance and reporting requirements are met.

Since January 1999, a majority of the nations in the European Union have been joined in economic and monetary union and have adopted the euro as their currency. Familiar currencies, such as the deutsche mark and the lira, no longer float in the currency markets, and foreign-exchange transactions that involve national (legacy) currencies must be calculated through the euro using fixed conversion factors.

During a three-year transition period (January 1, 1999, through January 1, 2002) entities doing business in Euroland can enter into and settle transactions in the legacy currency, the euro, or both and must be able to process and display transactions in both currencies.

Some Effects of the Euro on the Lodging and Restaurant Industry

The existence of the new euro could indirectly benefit the lodging and restaurant industry, in that Euroland countries engage in substantial trade and travel activities with the United States. The euro may diminish some of the U.S. dollar's prestige and cause a weakening of the dollar. A weak dollar could result in an increase in foreign tourists and thus boost business in the lodging and restaurant industry. Additionally, a weak dollar could result in an increase in U.S. interest rates. Higher interest rates would most likely curtail construction spending on new hotels and other lodging units, thus reducing the potentially risky construction boom occurring in the industry.

Accounting Issues

You may need to stay on top of accounting requirements resulting from the euro. Various issues will arise, such as how to translate a foreign subsidiary's financial statements when the euro is involved.

FASB Guidance. Topic D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU)*, of the FASB *EITF Abstracts* discusses accounting issues related to the euro. Topic D-71 addresses—

- Accounting for conversion costs associated with upgrading information systems.
- Preparing comparative financial statements for periods before the introduction of the euro.
- Cumulative foreign-currency translation adjustments.
- Applying hedge accounting during the transition period to preexisting hedges of firm commitments or anticipated transactions.
- Designating a contract denominated in euros (or a legacy currency) as hedge of a net investment or firm commitment denominated in a legacy currency.

Disclosures. Since the conversion to the euro is likely to have a material effect on U.S. entities that conduct a significant amount of business in Europe, euro-related disclosures in U.S. financial statements may be required. Disclosure obligations in filings with the SEC are discussed in SEC Staff Legal Bulletin No. 6 (www.sec.gov/rules/othern/slbcim6.htm.). Such disclosures may include trends or uncertainties expected to have a material effect on the financial statements, such as the implications of changes in the company's competitive environment or the significant costs associated with the conversion.

Executive Summary—Euro Generates Accounting Issues and Auditing Concerns

- Since January 1999, a majority of the nations in the European Union have been joined in economic and monetary union and have adopted the euro as their currency.
- The euro may indirectly benefit the lodging and restaurant industry.
- Topic D-71 of the FASB *EITF Abstracts* discusses accounting issues related to the euro.
- Euro-related disclosure obligations in filings with the SEC are discussed in SEC Staff Legal Bulletin No. 6.

Accounting Issues in the Spotlight: Staying Informed on Hot Topics

What's the latest news on hot accounting topics?

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

Effective Date Delayed

The FASB issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in June 1998, with an initial effective date of June 15, 1999. Citing concerns about companies' ability to modify their information systems and educate their managers in time to apply FASB Statement No. 133, the FASB has delayed its effective date for one year, to fiscal years beginning after June 15, 2000. The delay, published as FASB Statement No. 137, applies to quarterly and annual financial statements.

Implementation Guidance Available

The FASB created a task force known as the Derivatives Implementation Group to help answer significant questions that companies will face when they begin implementing FASB Statement No. 133.

The Derivatives Implementation Group has issued guidance on numerous FASB Statement No. 133 implementation issues. This guidance can be found and downloaded at the FASB Web site at www.fasb.org. Some of the many topics addressed by the implementation group include—

- Definition of a derivative.
- Embedded derivatives.
- Scope exceptions.
- Complex combinations of options.
- Hedging foreign-currency-denominated interest payments.
- Transition provisions.

Formal Documentation Under FASB Statement No. 133

Upon adoption of FASB Statement No. 133, an entity is required to designate all hedging relationships anew and must comply with the formal documentation requirements of the standard as of the date of adoption. The standard stresses the need for the formal documentation to be prepared contemporaneously with the designation of the hedging relationship. The items the formal documentation must identify include the following:

- The entity's risk-management objectives and strategies for undertaking the hedge
- The nature of the hedged risk
- The derivative hedging instrument
- The hedged forecasted transaction
- A description of how the entity will assess hedge effectiveness

When the hedged item is a forecasted transaction, the documentation of the hedged item must be sufficiently specific so when a transaction occurs, it is clear whether that particular transaction is the hedged transaction. The documentation also must specify the method to be used for assessing hedge effectiveness. FASB Statement No. 133 requires that an entity use the chosen method consistently throughout the hedge period to (1) assess, at inception of the hedge and on an ongoing basis, whether it expects the hedging relationship to be highly effective in achieving offset and (2) determine hedge ineffectiveness.

The SEC staff has challenged the appropriateness of hedge accounting when registrants have not complied with FASB Statement No. 133's formal documentation requirements.

Transfers of Securities at Date of Initial Application

Under the transition provisions of FASB Statement No. 133 (see paragraph 54), an entity may transfer, at the date of initial application of FASB Statement No. 133, any debt security classified as held-to-maturity pursuant to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, into the available-for-sale category or the trading category. Such reclassification shall not call into question an entity's intent to hold other debt securities to maturity in the future. The transition provisions further require that the unrealized holding gain or loss on a transferred held-to-maturity security be reported as part of the cumulative-effect-type adjustment of net income if transferred to the trading category, or as part of the cumulative-effect-type adjustment of accumulated other comprehensive income if transferred to the available-for-sale category.

The SEC staff believes that any security transferred from held-to-maturity pursuant to the adoption of FASB Statement No. 133 and sold in the same reporting quarter should have been transferred to the trading category. Thus, any unrealized gain or loss on the security that exists on the date of transfer would be reported in net income as part of the cumulative effect of adopting FASB Statement No. 133 and not included in the gain or loss on the sale of the security.

See the "Independence Standards Board Issues Guidance" section of this Alert for information about Independence Standards Board Interpretation 99-1, which provides guidance on the auditor independence implications of assisting your client with the implementation of FASB Statement No. 133.

Executive Summary—FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

- The FASB has delayed the effective date of FASB Statement No. 133 for one year, to fiscal years beginning after June 15, 2000.
- The FASB's Derivatives Implementation Group has issued guidance on numerous Statement No. 133 implementation issues.
- The SEC staff has challenged the appropriateness of hedge accounting when registrants have not complied with FASB Statement No. 133's formal documentation requirements.
- The SEC staff believes that any security transferred from held-to-maturity pursuant to the adoption of FASB Statement No. 133 and sold in the same reporting quarter should have been transferred to the trading category.

Hedge Accounting Issues

For lodging and restaurant companies that have not yet adopted FASB Statement No. 133, guidance related to hedge accounting includes FASB Statement No. 80, *Accounting for Futures Contracts*, and EITF Topic D-64, *Accounting for Derivatives Used to Hedge Interest Rate Risk*. You may also want to familiarize yourself with the following reminders about macro hedging and hedging with intercompany derivatives.

Macro Hedging

Under FASB Statement No. 80 (and as outlined in EITF Topic D-64), macro hedging is not permitted. Under FASB Statement No. 80, hedge criteria include (1) designation of a derivative instrument to an individual item or group of essentially similar items; (2) the probability of a high correlation of changes in the market value of the futures contract(s) and the fair value of, or interest income or expense associated with, the hedged item(s); and (3) enterprise risk reduction.

Hedging With Intercompany Derivatives

Fundamental to FASB Statement No. 80's enterprise risk reduction model is that the derivative hedging instrument be transacted with an unrelated third party. For any intercompany derivative instrument designated as a hedging instrument after January 1, 1999, there must exist documentation, prepared contemporaneously, which demonstrates that the notional amount, duration, interest rate risk, currency risk, commodity risk, and other risks associated with such intercompany derivative contracts have been laid off to unrelated third parties. For intercompany derivative contracts designated after January 1, 1999, that do not meet these requirements, an entity should eliminate their impact in preparing consolidated financial statements in accordance with Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*. In addition, these intercompany derivative contracts will not qualify as hedging instruments in the consolidated financial statements.

Segment Information

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, requires companies to report financial and descriptive information about their reportable operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available, and that is evaluated regularly by the "chief operating decision maker" in deciding how to allocate resources and to assess segment performance. The Auditing Standards Board has issued guidance in SAS No. 31 requiring, among other things, that auditors "review corroborating evidence, such as information that the chief operating decision maker uses to assess performance and allocate resources, material presented to the board of directors, minutes from the meetings of the board of directors, and information that management provides in management's discussion and analysis (MD&A), to financial analysts, and in the Chairman's letter to shareholders, for consistency with financial statement disclosures."

In some cases, financial statements of public companies have not conformed with the requirements of FASB Statement No. 131. Instances exist where: (1) the internal reporting package included operating information on more segments than were disclosed in the financial statements; (2) those additional segments were discussed in MD&A or analysts' reports; and (3) the company's executives also discussed the additional segments in press releases or business periodicals.

When reviewing segment information as part of its normal filing review and comment process, the SEC staff may ask registrants for a copy of the internal reports or other materials supplied to the chief operating decision maker of the company, as well as analysts' reports and press releases. Assuring quality implementation of FASB Statement No. 131 on segment disclosures is clearly in the interest of investors. Consequently, if the segment information provided in the financial statements does not reflect a similar breakdown of company segments as is evident in the internal reports and other materials, the SEC staff will seek amendment of the registrant's filings.

Fraud Update and Typical Audit Problems

Information and advice about fraudulent activities.

A number of high-profile cases involving fraud have been receiving attention lately in the U.S. Additionally, studies indicate that fraud is on the rise. Lodging and restaurant entities are vulnerable to the risk of fraud, including fraudulent financial reporting and the misappropriation of assets.

Fraudulent financial reporting perpetrated at lodging and restaurant entities often includes methods such as manipulating revenue recognition (see the "In Focus Special: Managing Profits" section of this Alert for a discussion of revenue recognition issues), capitalization of expenses, and refusing to write off impaired assets. Common methods used to misappropriate assets at lodging and restaurant entities include check fraud, procurement fraud, and simple theft.

Fierce Competition

Competition within the lodging and restaurant industries has grown especially intense of late. In the lodging sector, much of the fiercest competition is occurring in the suburban and highway markets among limited-service hotels. The restaurant industry is experiencing its toughest competition within its fast-food and limited-service sector. When auditing a client subject to intense competitive pressures, you should be concerned with the risk of material misstatement due to fraud.

Your Responsibilities Concerning Fraud

Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), states that auditors must plan and perform the audit to obtain reasonable assurance that material financial statement misstatements, whether caused by error or fraud, are detected. In addition, SAS No. 82 requires the auditor to assess the risk of material misstatement due to fraud and consider that assessment in designing the audit procedures to be performed. SAS No. 82 also provides guidance on how you can satisfy your responsibility.

SAS No. 54 Requirements

SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), prescribes the nature and extent of the consideration an auditor should give to the possibility of a client committing illegal acts in an audit of financial statements in accordance with GAAP. SAS No. 54 also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

SAS No. 82 Requirements

In planning an audit, you should consider fraud risk factors in accordance with the guidance contained in SAS No. 82. Judgment must be used in identifying fraud risk factors present on an engagement.

> **Help Desk**—In implementing SAS No. 82, you can consult the AICPA publication *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk).

Fraud Risk Factors You Should Be Aware of

Fraud is more likely to be perpetrated at entities that are small in size and are losing money, have weak audit committees that rarely meet, and have boards of directors filled with insiders and related parties. Moreover, senior management (for example, the chief executive officer) is often involved in the fraud.

Pressures such as meeting earnings expectations, making a merger work, and fierce competition within the industry can also increase the risk of fraud. In addition, entities that have enacted layoffs, downsizing, or new technologies may be more at risk for fraud.

Lodging and restaurant companies typically are involved in many cash transactions. They often lack an adequate segregation of duties and process a large volume of transactions. Such operating characteristics may elevate the risk of fraud.

Typical Audit Problems

The following audit problems often exist at many entities where significant fraud has occurred and gone undetected for some time. Knowing these factors will help you design and perform a more effective audit.

- Lack of objectivity and professional skepticism
- Not having the level of training or the expertise necessary to take on the engagement
- Auditing by conversation (that is, taking the word of management without independent verification of management's assertions)
- Not critically evaluating transactions (for example, not noting provisions of a contract that cause it to be nonbinding on one or both parties)
- Not exercising professional skepticism on unusual, last-minute, or related-party transactions
- Failure to perform audit procedures required by the audit program
- Failure to supervise subordinates
- Failure to obtain sufficient, competent evidential matter to support the opinion
- Allowing client access to working papers, thus compromising audit procedures

Help Desk—In March 1999, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released *Fraudulent Financial Reporting*: 1987–1997, *An Analysis of U.S. Public Companies.* This study provides an analysis of fraudulent financial reporting investigated by the SEC. Read *Audit Risk Alert—1999/2000* (Product No. 022250kk) for more information about this report.

Executive Summary—Fraud Update and Typical Audit Problems

- Fraudulent activities that are being perpetrated at lodging and restaurant entities include manipulation of revenue recognition, capitalization of expenses, failure to write off impaired assets, check fraud, procurement fraud, and simple theft.
- SAS Nos. 47, 54, and 82 explain your responsibilities regarding fraud and illegal activities.
- Fraud is more likely perpetrated at entities that are small in size and are losing money, have weak audit committees that rarely meet, and have boards of directors filled with insiders and related parties.
- Operating characteristics at lodging and restaurant entities that may increase the risk of fraud include large volume of transactions, especially cash transactions, and inadequate segregation of duties.
- Certain audit problems have been noted at many entities where significant fraud has occurred and gone undetected for some time. See the list in this section.

Recent SEC Regulatory Actions

Has important SEC regulatory guidance been issued recently?

SEC Issues New Definition of Improper Professional Conduct

The SEC adopted an amendment to Rule 102(e) of its Rules of Practice, which governs the conduct of accountants and other professionals who perform audits for public companies or otherwise practice before the SEC. Rule 102(e)(1)(ii) authorizes the SEC to censure, suspend, or bar from practice before the SEC a person who engages in "improper professional conduct."

Definition

Under the new rule, *improper professional conduct* is defined to mean—

- Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards.

- Either of the following two types of negligent conduct:
  - A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
  - Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicates a lack of competence to practice before the SEC.

SEC Issues Staff Accounting Bulletin No. 99, *Materiality*

The SEC staff has released SAB No. 99. This SAB addresses the application of materiality thresholds to the preparation and audit of financial statements filed with the SEC. The SAB does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature as well as in long-standing case law.

The SAB states that registrants and the auditors of their financial statements should not rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements. Equally important is a consideration of whether, in light of the surrounding circumstances, a reasonable investor would consider the item to be important. The SAB also states that management should not make intentional immaterial errors in a registrant's financial statements to "manage" earnings. It further reminds registrants of their legal responsibility to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB reminds auditors of their obligations to inform management and, in some cases, audit committees of illegal acts that come to the auditor's attention. The full text of the SAB can be viewed at the SEC Web site at www.sec.gov/rules/acctreps/sab99.htm.

SEC Staff Issues Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges*

The staff of the SEC has released SAB No.100, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges. The SAB reiterates the currently existing criteria stated in EITF Issue No. 94-3, EITF Issue No. 95-3, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-lived Assets to be Disposed Of*, and also provides guidance on how the staff interprets and applies those criteria.

It states that costs or charges falling within the scope of EITF Issue No. 94-3, EITF Issue No. 95-3, or FASB Statement No. 121 must be accounted for in accordance with the appropriate standard. It notes that EITF Issue No. 94-3, EITF Issue No. 95-3, and FASB Statement No. 121 should not be applied to events or circumstances falling outside their respective scopes. Furthermore, the SAB provides examples to illustrate the staffs' interpretations of how this accounting literature should be applied. Registrants are reminded of the disclosures required by EITF 94-3, EITF 95-3, and SFAS 121, as well as their required frequency.

In addition, investors are informed of additional disclosures that the staff has requested to enhance financial statement transparency. SAB No. 100 provides the staff's views regarding assessing and measuring enterprise level goodwill for impairment in accordance with Accounting Principles Board Opinion No. 17, *Intangible Assets*. The SAB also states that depreciable lives, amortization periods, and salvage values of long-lived assets need to be reviewed, and where appropriate, changed on a timely basis. Finally, the SAB provides the staff's views regarding the measurement of liabilities and other loss accruals assumed in a purchase business combination.

Auditing and Attestation Pronouncements and Guidance Update

What new auditing pronouncements and other matters do you need to be aware of?

For a full listing and description of all new auditing and attestation guidance, read *Audit Risk Alert—1999/2000* (Product No. 022250kk). At the time this Alert went to press, no new SASs had been issued during 1999.

Practice Alert 98-2, *Professional Skepticism and Related Topics*

This Practice Alert provides guidance to practitioners in two areas that may warrant a relatively high level of professional skepticism and attention to audit evidence: (1) the review of nonstandard journal entries and (2) the review of original and final versions of source documents rather than photocopies or draft versions in these two areas. This Practice Alert also provides a comprehensive list of previously issued Practice Alerts. Practice Alert 98-2 can be obtained at the AICPA Web site on the SEC Practice Section page.

Practice Alert 98-3, *Revenue Recognition Issues*

This Practice Alert is intended to remind auditors of certain factors or conditions that can be indicative of increased audit risk of improper, aggressive, or unusual revenue recognition practices, and the Practice Alert suggests ways in which auditors may reduce the risk of failing to detect such practices. This Practice Alert also refers to professional guidance that addresses the accounting considerations for revenue recognition, and it reminds auditors of their responsibilities to communicate with the board of directors and audit committee. This Practice Alert can be obtained at the AICPA Web site on the SEC Practice Section page.

Practice Alert 99-1, *Guidance for Independence Discussions With Audit Committees*

The AICPA has issued Practice Alert 99-1, *Guidance for Independence Discussions With Audit Committees*, to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating with audit committees those judgmental matters that may reasonably be thought to bear on the auditor's independence. The Practice Alert provides examples of certain relationships that may be thought to bear on the auditor's independence, safeguards to ensure independence, a sample letter to an audit committee, and other implementation guidance. Practice Alert 99-1 can be obtained at the AICPA Web site on the SEC Practice Section page.

Practice Alert 99-2, *How the Use of a Service Organization Affects Internal Control Considerations*

This Practice Alert helps auditors consider the guidance in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and the implications that a service organization may have to their audits. The Practice Alert addresses such topics as when the user auditor's planning should consider the guidance in SAS No. 70, factors to consider in assessing control risk, types of SAS No. 70 reports, and considerations in using the reports. Practice Alert 99-2 can be obtained at the AICPA Web site at www.aicpa.org/pubs/cpaltr/index.htm (go to July/August *CPA Letter*).

SAS No. 87 Reminder

SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), is effective for reports issued after December 31, 1998. You should be alert to any SAS No. 87-required changes to reports you may be issuing.

Proposed Statement on Auditing Standards—*Auditing Financial Instruments*

In June 1999, the ASB issued an exposure draft of a proposed SAS titled *Auditing Financial Instruments.* The proposed SAS would supersede SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and provide updated guidance on planning and performing auditing procedures for financial statement assertions about financial instruments.

The ASB expects to issue a final standard during the first quarter of 2000.

The exposure draft can be ordered from the AICPA Order Department by requesting product number 800131kk and can be downloaded from the AICPA Web site at www.aicpa.org/members/div/auditstd/drafts.htm.

Practice Aid Guidance to Accompany New SAS

We are developing a Practice Aid that will provide guidance on how to apply the proposed SAS to assertions about specific types of financial instruments and assertions based on specific accounting requirements. Excerpts from and information about the Practice Aid are available on the AICPA Web site. We plan on publishing the Practice Aid at the same time the ASB issues the proposed SAS.

Executive Summary—Auditing and Attestation Pronouncements and Guidance Update

- Practice Alert 98-2, *Professional Skepticism and Related Topics*
- Practice Alert 98-3, *Revenue Recognition Issues*
- Practice Alert 99-1, *Guidance for Independence Discussions with Audit Committees*
- Practice Alert 99-2, *How the Use of a Service Organization Affects Internal Control Considerations*
- You should be alert to any SAS No. 87-required changes to reports you may be issuing.
- Proposed Statement on Auditing Standards—*Auditing Financial Instruments*

Accounting Pronouncements and Guidance Update

What new accounting pronouncements and other matters do you need to be aware of?

For a full listing of recently issued accounting standards, read *Audit Risk Alert—1999/2000* (Product No. 022250kk).

FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*

This Statement rescinds FASB Statement No. 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units*. This Statement also amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to exclude from its scope plans that are sponsored by and provide benefits for the employees of one or more state or local governmental units.

This Statement also amends other existing authoritative literature to make various technical corrections, clarify meanings, or describe applicability under changed conditions. FASB Statement No. 135 is effective for financial statements issued for fiscal years ending after February 15, 1999. Earlier application is encouraged.

FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*

This Statement establishes standards for transactions in which an entity—the *donor*—makes a contribution by transferring assets to a not-for-profit organization or charitable trust—the *recipient organization*—which accepts the assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to another entity—the *beneficiary*—that is specified by the donor. It also establishes standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal.

This Statement incorporates without reconsideration the guidance in FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power,* and supersedes that Interpretation. This Statement is effective for financial statements issued for fiscal periods beginning after December 15, 1999, except for the provisions incorporated from Interpretation No. 42, which continue to be effective for fiscal years ending after September 15, 1996. Earlier application is encouraged.

FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*

FASB Statement No. 137 delays the effective date of FASB Statement No. 133 for one year, to fiscal years beginning after June 15, 2000. The delay applies to quarterly and annual financial statements.

FASB Interpretation No. 43, *Real Estate Sales*

This Interpretation of FASB Statement No. 66, *Accounting for Sales of Real Estate*, clarifies that the phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from real estate without incurring significant costs. The Interpretation is effective for all sales of real estate with property improvements or integral equipment entered into after June 30, 1999.

Proposed Elimination of Pooling-of-Interests Accounting

The FASB has issued a proposal for public comment that would, among other things, eliminate the pooling of interests method of accounting for business combinations. The FASB tentatively decided that using the purchase method is preferable to allowing more than one method to be used when businesses combine. The change will be effective for business combinations initiated after the FASB issues a final standard on the issues, which is expected to be late in 2000.

For information on this issue, visit the FASB's Web site at www.fasb.org.

Executive Summary—Accounting Pronouncements and Guidance Update

- FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*
- FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*
- FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*
- FASB Interpretation No. 43, *Real Estate Sales*
- The FASB has issued a proposal for public comment that would eliminate the pooling-of-interests method of accounting for business combinations.

Places to Find Additional Guidance

What are some organizations that provide information about the industry?

Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed at the end of this document. Many nongovernment and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Many private companies, professional and trade associations, and government agencies allow users to read, copy, and exchange information electronically through the Internet.

> **Help Desk**—Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in the general *Audit Risk Alert—1999/2000* (Product No. 022250kk) and *Compilation and Review Alert—1999/2000* (Product No. 022240kk), which may be obtained by calling the AICPA Order Department at (888) 777-7077.

Hospitality: Lodging and Restaurants Industry Developments—1999/2000 is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to rdurak@aicpa.org or write to:

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INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
American Hotel & Motel Association	1201 New York Ave. NW #600 Washington, D.C. 20005-3931 (202) 289-3100	(202) 289-3199	www.ahma.com	
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	*AcSEC Telephone Line* (212) 596-6008
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
Hotel Online			www.hotel-online.com	

(continued)

INFORMATION SOURCES—continued

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
International Hotel & Restaurant Association	251, rue du Faubourg St-Martin 75010 Paris, France 33 (0) 1 44 89 94 00	33 (0) 1 40 36 73 30	www.ih-ra.com	
National Restaurant Association	1200 17th Street NW Washington, D.C. 20036	(202) 973-3955	www.restaurant.org	
Occupational Safety & Health Administration	U.S. Dept. of Labor OSHA Office of Public Affairs - Room N3647 200 Constitution Ave. Washington, D.C. 20210 (202) 693-1999		www.osha-slc.gov	
Restaurant Report Online			www.restaurantreport.com	

Smith Travel Research	Music Village Boulevard Hendersonville, TN 37075 (615) 824-8664	(615) 824-3848	www.wwstar.com	
United States Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)